

Internal Revenue Service

memorandum

CC:TL-N-8413-88
Br4:RBWeinstock

date: **SEP 08 1988**

to: District Counsel, Kansas City
Attn: Dale P. Kensinger

from: Director Tax Litigation Division CC:TL

subject: [REDACTED]

TL-R-578-88

This is in response to your request for technical advice dated August 4, 1988, with respect to this refund case which deals with the application of the unrelated business income tax under I.R.C. § 512(a)(3) to an I.R.C. § 501(c)(9) organization.

ISSUE

Whether an I.R.C. § 501(c)(9) organization is subject to the tax on unrelated trade or business income on that portion of the purchase price of an office building (bought with exempt function set aside income) which is not used for the organization's exempt purposes.

BACKGROUND

The plaintiff organization provides insurance to its members. It purchased an office building in [REDACTED] for its operations, paying \$ [REDACTED] in cash. It occupied the building in [REDACTED], initially occupying less than [REDACTED] percent of the building's total space, and rented out the remaining portion.

Because over [REDACTED] of the building was not used in support of its exempt function, the Service treated one-half of the purchase price as a withdrawal of an amount set aside for an exempt function within the meaning of I.R.C. § 512(a)(3)(B), and thus subject to the tax on unrelated business taxable income under I.R.C. § 512(a)(3)(A). A technical advice memorandum (copy enclosed) which was reviewed by the Employee Plans and Exempt Organizations Division (CC:EE) and Tax Legislative Counsel was issued in April, 1986, by the Exempt Organizations Technical Division (OP:E:EO), stated that the cost of the building to the extent it was not used by the exempt organization was not a reasonable cost of administration, although no detailed legal analysis was provided. After paying the tax, the organization

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filed a refund claim, and subsequently filed the above-entitled refund suit in District Court. The amount in suit is \$ [REDACTED] plus statutory interest for the year ended [REDACTED].

The organization contended at the time it purchased the building that its future need for space justified the acquisition of a building larger than required for its then current operations. Also, the building was obtained at a bargain price so that it was cheaper to buy the building than to build a building to meet its then current needs. As the organization states at page 5 of its refund claim statement, "A decision to purchase a building which would only satisfy [REDACTED]'s immediate needs, providing no room for growth, would have forced [REDACTED] almost immediately to begin additional construction or relocate. Such a decision would not have been prudent."

In its refund claim, the organization states that upon relocation to the building it initially occupied [REDACTED]% of the total work space. Also because substantial portions of the common area are required even if it was the only occupant, it claimed its percentage usage of the building's total space was [REDACTED]%. It states that its membership has steadily increased and so has its use of the building. On [REDACTED], it occupied [REDACTED]% of the total available space, and in [REDACTED] this figure was [REDACTED]%. It appears, but is not totally clear, that these percentages include the common areas. If the common areas are not considered, then it would appear that [REDACTED] percent of the available work space is still rented. Plaintiff eschewed long term leases so space would be available to it and its membership is still growing.

No pre-trial discovery has yet been conducted, and therefore, the organization's assertions are unverified. If true, the increase in the organization's usage of the building provides credence to its contention that the future need for space justified purchase of a building larger than actual usage at time of occupancy and will be looked upon by the District Court very favorably.

Since, the technical advice memorandum acknowledges that the purchase of the building is a reasonable cost of administration, the issue comes down to one of fact, i.e., what is a reasonable size office building under the facts and circumstances of this case. While a substantial portion of the building is still being rented, and indicates that the space of the building was in excess of then reasonably anticipated needs at time of purchase, it is our view that the weight of the evidence in this case is with the plaintiff, unless pre-trial discovery reveals additional facts favorable to the Government (which we doubt). In addition to the organization's substantially increased use of the building's space, the Court is also likely to be influenced by

the fact that the purchase of the building was a bargain, and in fact, cost less than the cost of a new building that would have satisfied its then current needs.

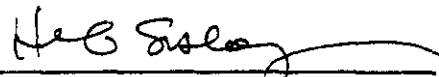
RECOMMENDATION

Therefore, subject to discovery and confirmation of the facts, we believe that this case is suitable for settlement on the most favorable terms that can be obtained (preferably under \$ [REDACTED] so that no submission to the Joint Committee on Taxation would be necessary). Our advice has been coordinated with the Employee Benefits and Exempt Organizations Division (CC:EE) and the Exempt Organizations Technical Division (OP:E:EO).

If you have any questions or require further assistance, please contact Ronald Weinstock at 566-3345.

MARLENE GROSS
Director

By:


HENRY G. SALAMY
Chief, Branch No. 4
Tax Litigation Division

Enclosures:

Revenue Agent's Report
Claim for Refund
Technical Advice Memorandum
Copy of Technical Advice Memorandum File